Audits of Automobile Dealerships

If you are in certain retail businesses, industry specific audit procedures may be performed by the IRS in addition to the standard procedures performed during an audit of all retail businesses. Below are industry audit procedures performed for audits of used automobile dealerships.

Independent Used Automobile Dealerships

Introduction

The used car industry is composed of new car dealers who accept trade-ins on the sale of new automobiles and can also purchase used vehicles directly from customers, other car dealers, or at wholesale auto auctions, and independent auto dealers. These dealers are not affiliated with an automaker and, their principal business is the sale of used vehicles.

Initial Interview

When examining an independent used vehicle dealer the examiner will perform standard interview questions. These may consist of one or more of the following industry specific questions.

Sales:

1. Do you keep a personal record or list of your profits on each vehicle or deal?
2. What types of sales transactions did you have for the year under examination?
3. Any sales at auctions? If yes, which?
4. Any sales to wholesalers? If yes, which?
5. Any sales to other dealers? If yes, which?
6. Any consignment sales? If yes, volume?
7. Any scrap sales? If yes, describe.
8. Any in-house dealer financing sales?
9. Any third-party financing sales?
10. Did you have any other types of sales transactions?
11. Did you have any sales that resulted in a loss on the sale? If yes, describe the nature of these sales.
12. Is there interest income on dealer-financed sales?
13. Are there commissions or referral fees on third-party financing?
    - What third party financiers did you use?
    - What was the fee/commission arrangement?
    - Are there commissions or referral fees on vehicle insurance placement?
    - Which insurance companies were used?
    - What was the fee/commission arrangement?
        - Are there commissions or referral fees on warranty/repair placement programs?

    - What other commission/referral fee arrangements do you have income from?
    How are sales recorded?
- When selling a vehicle, how do you report the sale?
- What are the typical gross sales prices per sales contracts?
- What is the net cash received upon sale after discount and/or trade-in?
- Are sales taxes reported in the gross sales price?
- Are licensing fees or titling fees included in the sales price? (If the answer is no, examiners will look for these in expenses and make necessary adjustments)

Do you sell warranty or service contracts?

- How do you record the income from them on the books?
- How do you record the expense items on the books?

Do you finance sales?

- How do you record the income from the financing on the books?

Do you sell finance contracts?

- How does this transaction work?
- Who do you sell finance contracts to?
- Do you own or are you a shareholder of the finance company?
- Do you have a dealer reserve account at any financial institution?

What other goods or services do you provide in your business? How are these transactions reported on the books?

- Vehicle repairs?
- Portering/detailing services?
- Vehicle mats, etc.?

What are the typical pricing policies and discounts?

- When setting an asking price for a vehicle, what information sources do you consult, for example, Blue Book?
- When valuing a trade-in vehicle, what method do you use, that is, resale value to a customer, wholesale value to another dealer, or some other method such as personal judgment?
- How do you arrive at the amount of discount you recognize on a sale?

When overvaluing a trade-in how do you record it on the books? How do your record this paper loss?

When recording a sale of a trade-in on the books, how are the ACV and the discount recorded on the books?

Inventory Items

1. When setting an inventory value for a vehicle, what information sources do you consult, that is, Blue Book?
    - Do you ever change this value?
    - How is this change in value recorded on the books?

- What factors are considered when changing the inventory value?
- Do you always use one official valuation guide or do you consult more than one?
- For any vehicle that is valued below cost, how does the asking price at any point in time differ from the value recorded on the books at year-end?

2. If a vehicle is portered or repairs are made to it for resale, how do you record these costs?
   - Current expense?
   - Added to the value of the vehicle?
3. When junking a vehicle for scrap, how do you account for it?
   - What value is used for vehicles in ending inventory?
   - Does this value differs from the one originally recorded at the time of acquisition?
   - In determining the yearly LIFO index, what is the vehicle in ending inventory compared to in the ending inventory of the preceding year (that is, your cost for the same type of vehicle or a "reconstructed" cost from an official valuation guide for the same type of vehicle at the beginning of the year)? The examiner will be seeking information on how these vehicles are comparable.

Miscellaneous

1. Have you ever taken items other than vehicles in trade?
   - How was this accounted for on the books?

What titling regulations are you responsible for as a licensed vehicle dealer?

What do you use as a log/record of titles for all vehicles sold for the year? The examiner will likely request to inspect these records.

Do you acquire vehicles at auctions?

- If yes, which auctions?
- Which, if any, are out of state?

Do you acquire vehicles from wholesalers?

- If yes and a few are used, which wholesalers are used?
- If yes, and many are used, who are the primary wholesalers?
- What out of town wholesalers do you use?

What other non trade-in sources of vehicles do you utilize?

- What business names do they operate under?
- Are any of these businesses out of state?
- If yes, which ones are out of state?

How can I identify how a vehicle was acquired for resale?

How do you gauge the used vehicle market at any given time?

How does this affect your pricing and valuation practices?

If you use a vehicle for business, what records do you keep?

Books and Records

Accounting methods

Used car dealerships normally maintain an inventory, which is a material income producing item. Material income producing items are required to be accounted for under an accrual method of accounting. Nationwide, many used car dealerships have been found to be using an improper accounting method, either the cash method or the installment method. The examiner will verify that you are keeping records on the accrual method of accounting rather than the cash method or another method.

Income

Income reporting

There are certain issues in dealer income recognition that agents consider during an audit. These include:

- Not recording a trade-in on a sale, then selling the trade-in for cash. This avoids reporting the income in gross sales. Indications that this may be occurring include unidentified cash deposits, reconditioning costs incurred about the same time as the sale of the trade-in, but not allocated to vehicles, substantial sales discounts, or sales contracts that show a trade-in allowance with no corresponding stock number assignment.
- Reporting net sales based on financing obtained, omitting cash received. Comparing the sales contracts with the financing files discloses this problem to the examiner. Therefore, examiners are likely to review these files to test for compliance. Also, the state sales tax can be used to determine the sales price. These amounts may then be traced to the accounting records to verify that you did not understate taxable income.
- Not reporting the sale of all cars purchased. To test whether you understated income, examiners may compare the purchase of vehicles acquired by trade and at auctions to a subsequent sale of that vehicle. This can provide information on accuracy of sales figures. Also, examiners will look for your claimed travel expenses. This can tell them information about auctions attended where possible purchases occurred or sales were made.
- Purchasing a group of cars, allocating the entire purchase price to only some of the units; then selling one or more units off the books. A review of your purchase documents may provide evidence of the number of cars purchased. Furthermore, an analysis of the cost assigned to the inventoried cars you acquired in the package will likely be conducted for reasonableness.
- Independent used car dealers may take almost anything as a trade-in. Boats, trailers, snowmobiles, campers, etc. may be accepted as a trade-in. These traded items may or may not end up on the lot for sale. The examiner will look to see whether you are getting personal use of these items and selling them on the side as personal property instead of inventory.
- Vehicles taken in as trades may not be issued a separate stock number. It is a common industry practice for the new trade-in to be assigned a stock number that is based on the original stock number.

- In some parts of the country, used car dealers have been found to be members of bartering clubs. These activities are frequently excluded from income and examiners may perform inquiries to determine if this is occurring.
- Some state Departments of Transportation/Motor Vehicle require all car dealers to maintain a record book of all used cars purchased and sold. Examiners will likely make use of this log to help in determining inventory and cost of goods sold, as well as to verify that all items are included in gross receipts.

Fee Income

Auction fees are payments collected by a dealer for purchasing a particular vehicle for a customer at auction. The best way examiners check for auction fee income is to obtain a print out of the vehicles purchased from auctions that you do business with and spot check the listings for inclusion in income. They will check for unusual purchases, such as vehicles that are not of the character of those you typically sell. Bird Dog Fees are a form of commission payment also known as finder or referral fees. These fees are generated by:

1. Serving as a broker between two dealers/wholesalers, etc.
2. Finding a retail buyer for another dealer.

These fees are often paid in the form of a check written directly to the dealership or in cash. Many dealerships will claim these fees as an expense, but very few dealerships claim the income. Examiners will search for these line items in expenses and reclassify them to income.

Rebate Income

To assess whether income from finance rebates exists, examiners will look at the dealer agreement with the finance company, loan proceeds and recorded income. You will be asked to provide account statements to determine the transactions in the reserve account. A listing of contracts financed, the amount financed and the withheld amount will also be reviewed by the examiner. Furthermore, they will look at the title work or lien, checking for common finances sources. If you record deposit sources, the examiner will likely attempt to spot check the deposit slips.

Sales taxes, registration and licensing fees

Sales taxes and registration/license fees are collected by the dealer and paid to the state. In most states, used car dealers are required to charge sales tax on all retail sales. Many municipalities have their own retail sales taxes, which the dealers are also required to collect. In several states, autos with a lien will be charged an additional fee to register the lien. The lien fee is normally passed on to the customer. New license plates may or may not be required when the vehicle is sold, depending on state law. If license plates are necessary, many states require the dealer to collect the fee from the buyer and submit the additional amount to the state.

The dealer may also have income from sales to other dealers or wholesalers and from the sale of vehicles at wholesale or retail auctions. Sales to other dealers are not subject to sales tax in many states. Examiners will check state and local laws to determine whether sales taxes are applied to wholesale auto transactions. Some dealers include these fees in gross receipts and deduct the amounts paid to the state as an expense. Other dealers will not include these amounts in income or expenses. The examiner will verify that you are appropriately recording these transactions and not double counting by deducting items from expenses while excluding the items from income.

Purchases from Other Dealers

Accounts receivable

While new car dealerships have very detailed receivables and separate schedules for each type, the independent used car dealership may have no detailed receivable information. Many used car dealer returns show no accounts receivable. They will not accept any terms other than cash on delivery of the vehicle. Others may allow selected buyers to pay a portion of the purchase on delivery and accept payments for the rest. The full amount may not be shown in gross receipts when the sale is made. Frequently, the sales are recorded as the payments are received. The balance due may be kept in a separate book, index cards, or recorded on the deal-sheets.

This deferral of income from an installment sale is not permitted. Examiners will ensure that revenues are recorded when earned rather than when received. The absence of accounts receivable or an unusually low amount may indicate to an examiner that you have not appropriately accounted for your receivables in revenue. They are looking at your entries to make sure all sales are reported and are appropriately recorded for a tax year.

To test this, examiners may **s**ample deal sheets, checking for terms of the sale, and review sales recorded in the opening days of the next tax year to determine whether sales are includible in the year under examination, or to determine whether the full amount of the sales price involving payment plans was recorded as income at the time of the sale.

Expense Issues

Commissions and fees

Contracts between employer and employee should specify how commission wages are determined. The examiner may ask to see a sample of these contracts to ensure that you have not overstated these expenses on your tax return.

Related Finance Company

A dealer can use a related finance company (RFC) to discount its receivables and have it accepted for tax purposes. If used, the following three factors will be addressed by the examiner:

- The discounting transactions must have economic substance. All of the relevant facts and circumstances must be considered. The primary reasons for selling receivables are to obtain cash (improve cash flow) or to shift risk. If both of these are missing, it is a good indication that the sales transaction lacks economic substance and will not be accepted by the examiner.
- The form of the transactions and the form of the RFC must be perfected.
- The receivables must be sold for fair market value. The seller and purchaser must base the discount on some reasonable factors, not on an arbitrary determination of the discount rate.

What is a Non-Prime or Sub-Prime Finance Contract?

Because of poor credit, many potential vehicle purchasers cannot obtain financing directly from banks, credit unions or manufacturers' finance companies. These individuals are referred to as —non-prime or sub-prime consumers, depending on their credit rating. To tap into this large market, many vehicle dealerships (particularly used car dealerships) have established relationships with lenders who have dealers execute their own retail installment agreements to these customers. These contracts are known in the industry as non-prime or —sub-prime financing.
There are several dealership issues associated with the tax reporting of non-prime and sub-prime contracts, including the following that examiners are trained to spot:

- Determination of whether the transfer of the contract from the dealership to the finance company is a sale of the contract or a pledge of the contract to collateralize a loan made to the dealership by the finance company.
- Reporting of cash advances.
- Reporting of the payment of the fixed percentage collection fee.
- Evaluation of potential contingent payments for back-end distributions.
- Timing of when back-end distributions are reported.
- How back-end distributions are valued.
- How interest is computed and reported.
- How enrollment fees and capping fees are reported.
- Adjustments resulting in a change in accounting method.
- The transfers of customer notes from a used car dealership to an unrelated finance company are sales.
- The dealer's amount realized on the sale equals the cash received from the finance company plus the fair market value of the dealer's right to receive future distribution payments.
- The FMV of the future payments is not necessarily $0.
- The distribution payments are contingent and subject to the rules of IRC §483(f).
- Each distribution payment must be allocated to principal and interest.

Audit Techniques

In addition to the initial audit interview questions above, the examiner may ask you if any retail installment agreements for the customer purchases of vehicles are transferred to any unrelated finance companies if you deal with a RFC. They may also interview the accountant or preparer to see if they are aware of the transferring of finance contracts.

Sub-Prime Records

You will likely be asked to provide the vehicle jackets. These jackets are usually an envelope (or sometimes a file folder) for each vehicle, which includes all of the dealer‘s documentation related to that vehicle such as the sales invoice, purchase invoice, copy of the title, and repair receipts. The outside of the jacket often also lists detailed information about the vehicle‘s purchase and sale, including the dates, amounts, and individuals or companies involved. These jackets also may contain the dealer‘s records pertaining to the transfer of the installment contract to the finance company.

The examiner will look through the jacket for a retail installment agreement specifying how the customer will pay for the vehicle. Sometimes the retail installment agreement specifically states that it will be transferred to a finance company. In addition, the dealer usually receives a payment voucher from the finance company that shows the customer‘s name and amount received, and these vouchers may be in the vehicle jacket.

The dealer also prepares other paperwork as required by the finance company, copies of which have been kept and retained in the jacket or a separate finance file. This includes the non-prime or sub-prime customer‘s verification of employment and utility bills to show the home address, the computation of the advance to be received from the finance company, the insurance information form, and the notice of security interest.

If it is determined that you transferred finance contracts to an unrelated finance company, additional information will be requested from the examiner such as:

1. Servicing Agreement (also referred to as the dealer agreement). The Servicing Agreement defines the responsibilities of the dealer and the finance company. It provides definitions, explains the advances and how the collections will be applied, and shows how the agreement can be terminated. In addition, if the finance company changes the advance computation or other provisions of the agreement, an addendum or other notification of the changes may be provided to the dealer by the finance company. This assists the examiner in determining how items should be recorded.
2. Dealer Manual & Other Literature. The dealer Manual may contain various items of information, including a sample of customer paperwork with detailed advance computations. The finance company may also send the dealer literature on new programs or new features such as pool capping.

3. Account Statements -The finance company sends statements (usually monthly) to the dealer summarizing advances, collections, fees, and other pertinent information. The summary may also show detail by customer of the last payment date, amount of payment, and if the account was written off as a bad debt.

Brown, PC represents clients in the independent used automobile industry throughout Texas and across the United States. If you have questions regarding an IRS Audit, please call 888-870-0025 or contact us online for a confidential consultation.